NEW YORK ESTATE TAX ON REAL AND TANGIBLE PROPERTY - WHEN INTANGIBLES BECOME TANGIBLE

Nina Krauthamer

Real property, including personal use property, is frequently held by entities rather than directly by individuals. This may be done, for example, to preserve anonymity, limit liability or for estate planning purposes. Questions have arisen as to the New York Estate Tax treatment of real property that is not owned directly by a nonresident (non domiciliary) decedent, but rather by an entity in which the decedent had an interest. This entity could be a single-member or multi-member LLC, a regular “C” corporation or “S” corporation, or a trust (revocable or irrevocable).

New York State’s ability to impose its Estate Tax on a transfer of property of a deceased individual who was not a resident (domiciliary) of New York at death is limited. Generally, with limited exceptions, New York, by statute, is only permitted to impose its Estate Tax on real and tangible personal property having an actual situs in New York State where the property is includible in the decedent’s federal gross estate. N.Y. Tax Law Secs. 957, 960.

New York State’s Estate Tax rules generally track New York State’s Probate law. A Petition for Ancillary Probate, for example, makes reference to personal property and improved and unimproved real property (and certain rents) situated in New York. NY SCPA Sec. 206. While the statute makes reference to certain types of intangibles, New York ordinarily has jurisdiction only over property that has its physical situs in New York. Intangible personal property, with some exceptions, owned by a non domiciliary would therefore be subject to probate in the state of domicile, and not New York.

An interest in an entity is ordinarily characterized as an intangible asset. Despite the literal, and one could argue, clear meaning of New York’s Estate Tax statute, the New York State taxing authorities have issued Advisory Opinions strongly suggesting that New York would treat the ownership of the intangible as the ownership of the underlying real property in the following situations:

- Where the decedent was the sole member of a single-member LLC (treated as a disregarded entity for tax purposes), unless an election is made to characterize the entity as a corporation for income tax purposes. Shares in an S corporation will generally be treated as an intangible. New York Advisory Opinion No. TSB -A - 08(1)M, 10/24/2008. However, even in the case of an S corporation, New York State seems to impose a “business purpose” requirement, citing Moline Properties v. Commissioner of Internal Revenue, 319 U.S. 436, 438-439 (1943) (a corporation’s separate existence will be recognized for tax purposes “so long as [its] purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation.”)
In the case of a revocable trust, New York State will consider the nature of the property in the revocable trust. If the decedent is the grantor of a revocable trust directly owning New York real property, New York Estate tax would be imposed. Ownership of a revocable trust indirectly owning real estate through a partnership or LLC may escape New York Estate Tax where the decedent never used or owned the partnership/LLC real property or participated in its management. In that case, the decedent would be treated as if he or she owned an intangible asset. New York Advisory Opinion No. TSB - A -10(1)M, 4/8/201 New York Advisory Opinion No. TSB - A -11(1)M, 10/12/2011. Interests in an irrevocable trust may escape NY estate tax if not includible in the decedent’s federal gross estate.

The New York taxing authorities appear to have imported income tax concepts into their Estate Tax analysis, with questionable legal basis. In fact, the New York State income tax rules are more pro-taxpayer. As a result of a legislative change in 2009, New York, for income tax purposes, will tax as New York source income a sale of an interest in a partnership, LLC, S corporation, and a non-publicly traded C corporation with 100 or fewer shareholders, but only if the entity owns real property in New York and the fair market value of the New York real property is at least 50% of the fair market value of all the entity’s assets owned for at least two years. The gain or loss derived from New York sources from the taxpayer’s sale or exchange of an interest in such an entity is the total gain or loss for federal income tax purposes from that sale or exchange multiplied by a fraction, the numerator of which is the fair market value of the real property located in New York on the date of sale or exchange and the denominator of which is the fair market value of all the assets of the entity on the date of sale or exchange. The New York Estate tax position is therefore broader than the income tax laws, with less of a statutory basis.

For estate tax purposes, barring a legislative change, the status of an interest in an entity should not depend on whether or not the entity is a pass-through or disregarded entity for income tax purposes. There is little logic in subjecting real property owned by a single member LLC, when the same property owned by the single member LLC that elects to be taxed as a corporation (“S” corporation or otherwise) would escape taxation. For corporate law and non-tax liability purposes, there is no distinction in treatment between an LLC that has made the tax election and one that has not, and interests in both should be treated as intangible for NY estate tax purposes.

For many foreign individuals (non resident aliens), New York State’s position should pose no issues. Foreign individuals are generally advised for federal estate tax purposes to acquire real property through corporations or irrevocable trusts. In those circumstances, the possibility of New York taxation of the underlying real estate would be remote.

For a U.S. citizen (or resident alien) who is not a New York resident (domiciliary), however, New York’s position could be problematic, particularly in the case of personal use real estate. Even if those individuals purchase through entities to avoid ancillary probate, New York may nevertheless attempt to impose its estate tax depending on the
type of entity, the tax elections made by that entity and the use of the real estate by the entity.

1 Nina Krauthamer is a Partner at Olshan Frome Wolosky LLP in New York. Nina focuses her practice on federal, state and international tax matters involving public and private companies and not-for-profit organizations. She can be reached at nkrauthamer@olshanlaw.com.